

## The California Public Employees' Retirement System

The California Public Employees' Retirement System (CalPERS) is the nation's largest public pension fund and the third largest in the world, with assets at June 30, 1997 of approximately \$120 billion.

Headquartered in Sacramento, CalPERS provides retirement and health benefit services to more than 1 million people and more than 2,400 public employers. The System also operates seven offices located in San Francisco, Los Angeles, Orange County, San Bernardino, San Diego, Mountain View, and Fresno.

CalPERS is led by a 13-member Board of Administration, consisting of member-elected, appointed, and ex-officio members.

Our membership consists of 750,712 active and inactive members from the State, school districts, and local public agencies, and 321,312 retirees, beneficiaries, and survivors.

Established by legislation in 1931, the System became operational in 1932 for State employees only. In 1939, other public agencies were allowed to contract with CalPERS to provide retirement benefits for their employees. We began administering health benefits to State employees in 1962 under the Public Employees' Medical and Hospital Care Act. Local public agencies joined in our health program on a contract basis five years later.



### **EPERS**

The California Public Employees' Retirement System

## Annual Investment Report

Year Ended June 30, 1997

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### Investment Committee Chairman's Message

On behalf of the CalPERS Board of Administration, I am pleased to present our Annual Investment Report for the fiscal year ended June 30, 1997.

This report provides an overview of the Fund's investment performance and presents highlights and statistics of our investment programs and portfolios.

The 1996-97 fiscal year marked one of the largest annual gains by the System in recent years. We earned a 20.1 percent return on our investments, exceeding last year's performance of 15.3 percent. This stellar performance helped earn more than \$19 billion during the year, bringing the Fund's total portfolio market value to \$119.7 billion as of June 30, 1997.

During the year, we continued to increase the Fund's exposure to the U.S. equity market—a decision that served as the foundation of the Fund's successful performance. We developed and began implementing comprehensive investment strategies in our alternative investment and private equity, real estate and public market portfolios to ensure strong earnings and prudent management of risk. We broke tradition and tapped some of today's cutting-edge technology to help identify some of the best and brightest investment firms in the industry. We set forth corporate governance standards in the United Kingdom and France, and we expanded our corporate governance leadership into the private equity market calling for better terms, fees and conditions with our general partners. We continued to invest in our state, providing a powerful economic stimulus to California's growth.

For a second year, CalPERS excellent investment performance came at a low cost to the System. We achieved value-added investment results equal to or in excess of other large multi-million dollar corporate and public pension funds without sacrificing the quality of our investment program.

Over the next year, CalPERS Board will remain steadfast in its duty to ensure continued growth while managing the internal and external risks to the System. As trustees to the Fund, we will continue to seek out safe and prudent investments for the long-term benefit of the Fund. With this commitment, we will build the best retirement and financial security possible for all our members and their beneficiaries for years to come.

Sincerely,

CHARLES P. VALDES, CHAIRMAN INVESTMENT COMMITTEE

### ANNUAL INVESTMENT REPORT

Year Ended June 30, 1997

### CalPERS Board of Administration

WILLIAM DALE CRIST *President* 

CHARLES P. VALDES

Vice President

RONALD ALVARADO

ROBERT F. CARLSON

THOMAS J. CLARK

KATHLEEN CONNELL

MIKE QUEVEDO JR. (Jerry Cremins thru March 1997)

MICHAEL FLAHERMAN

MATT FONG

WILLIAM ROSENBERG

KURATO SHIMADA

JOSEPH THOMAS (Harry Bubb Thru March 1997)

DAVID TIRAPELLE

#### Investment Committee

All members of the Board serve on the Investment Committee. Charles P. Valdes serves as the Committee Chair and William D. Crist is Vice Chair. This Committee reviews investment transactions, the work of staff and consultants, and establishes investment strategy and asset allocation.

#### CalPERS Executive Staff

James E. Burton

Chief Executive Officer

James H. Gomez

Deputy Executive Officer

SHERYL PRESSLER

Chief Investment Officer

Investment Operations

ROBERT AGUALLO

Assistant Executive Officer

Investment Operations

VINCENT P. BROWN

Assistant Executive Officer

Financial & Administrative

Services

Kayla Gillan

General Counsel

Barbara Hegdal Assistant Executive Officer Member & Benefit Services

PATRICIA K. MACHT

Chief, Office of Public Affairs

RON SEELING

Chief Actuary

Actuarial & Employer Services

Margaret Stanley

Assistant Executive Officer

Health Benefit Services

ROBERT D. WALTON

Assistant Executive Officer

Governmental Affairs, Planning

& Research

#### **Consultants**

WILSHIRE ASSOCIATES

Pension Consultant

Pension Consulting Alliance/ Kenneth Leventhal & Co. Real Estate Consultant

Hamilton Lane Advisors, Inc. Pacific Corporate Group, Inc. Alternative Investment Management Program

#### Custodian

STATE STREET BANK AND TRUST COMPANY

### Mainstream Domestic Equity Managers

DIMENSIONAL FUND ADVISORS, INC.

OPPENHEIMER CAPITAL
MANAGEMENT

RCM CAPITAL MANAGEMENT

STATE STREET BANK AND TRUST COMPANY

### ANNUAL INVESTMENT REPORT (CONTINUED)

Year Ended June 30, 1997

Small & Emerging Domestic
Equity Managers

AMERINDO INVESTMENT ADVISORS, INC.

Brown Capital Management. Inc.

OAK ASSOCIATES, LTD.

Spare, Kaplan, Bischel & Associates, Inc.

TIFFANY CAPITAL ADVISORS. INC.

VALENZUELA CAPITAL MANAGEMENT, INC.

VALUEQUEST LTD.

### International Fixed-Income Managers

BARING INTERNATIONAL INVESTMENT, LTD.

FIDUCIARY TRUST COMPANY INTERNATIONAL

Julius Baer Investment

Management, Inc.

MERCURY ASSET MANAGEMENT INTERNATIONAL, LTD.

### Global Asset Allocation Managers

BRINSON PARTNERS. INC.

TCW ASSET MANAGEMENT
COMPANY

International Equity Managers

MORGAN GRENFELL INVESTMENT SERVICES, LTD.

NEWPORT PACIFIC MANAGEMENT, INC.

NOMURA CAPITAL MANAGEMENT, INC.

OECHSLE INTERNATIONAL ADVISORS, L.P.

PARIBAS ASSET MANAGEMENT, INC.

SCHRODER CAPITAL MANAGEMENT INTERNATIONAL, INC.

STATE STREET GLOBAL ADVISORS (PASSIVE)

ValueQuest, Ltd.

Currency Overlay Managers

**BEA ASSOCIATES** 

PARETO PARTNERS

STATE STREET GLOBAL ADVISORS

Real Estate Advisors & Partners

AMB Institutional Realty Advisors, Inc.

AMRESCO ADVISORS, INC.

CNL NET LEASE INVESTORS, L.P.

COMPASS MANAGEMENT

ERE YARMOUTH

GE CAPITAL INVESTMENT ADVISORS, INC.

General Investment &

DEVELOPMENT

HANCOCK TIMBER RESOURCE GROUP

HEARTHSTONE HOUSING PARTNERS, L.P.

IBEX INSTITUTIONAL ADVISORS

Institutional Housing Partners

KENNEDY ASSOCIATES REAL ESTATE

Counsel, Inc.

LaSalle Advisors, Ltd.

JOHNSON/MACFARLANE PARTNERS

MACFARLANE/WEYERHAEUSER

NEWLAND CAPITAL ADVISORS

OLYMPIC REALTY ADVISORS

PICAL, L.P.

PRUDENTIAL REALTY GROUP

RREEF AMERICA PARTNERS, L.P.

RESIDENTIAL R.E. PARTNERS, L.P.

SENTINEL REAL ESTATE

CORPORATION

SSR REALTY

WESTMARK REALTY ADVISORS

WFHAI HOUSING FUND, L.P.

W.P. CAREY & CO., INC.

## SUMMARY OF SECURITIES OWNED

Category	Book Value	Market Value	% of Investment at Market Value
CASH EQUIVALENTS & RECEIVABLES/PAYABLES			
DOMESTIC CASH EQUIVALENTS			
Internal Domestic Cash Equivalents			
Cash Equivalents	\$1,903,962,329	\$1,903,958,364	1.59%
State Pooled Money Investment Fund	350,468,000	350,468,000	0.29
Total Internal Domestic Cash Equivalents External Domestic Cash Equivalents	\$2,254,430,329	\$2,254,426,364	1.88%
Cash Equivalents	\$1,287,320	\$1,287,320	0.00
U.S. Treasuries & Agencies	34,069,607	34,073,582	0.03
Total External Domestic Cash Equivalents Total Domestic Cash Equivalents	\$35,356,927 \$2,289,787,256	\$35,360,902 \$2,289,787,266	0.03% 1.91%
External International Cash Equivalents			
Foreign Currency	\$77,487,338	\$76,910,288	0.06
NET INVESTMENT RECEIVABLES/PAYABLES	\$464,821,042	\$464,821,042	0.39
TOTAL CASH EQUIVALENTS & RECEIVABLES/PAYABLES	\$2,832,095,636	\$2,831,518,596	2.36%
FIXED-INCOME  DOMESTIC FIXED-INCOME  Internal Domestic Fixed-Income  Mortgage-Backed Securities:			
FHLMC	\$1,705,216,756	\$1,728,447,393	1.44%
FNMA	2,072,296,241	2,095,477,517	1.75
GNMA	254,986,420	264,372,830	0.22
Other Mortgages	5,497,200,627	5,674,063,065	4.73
U.S. Treasuries & Agencies:	, ,	, , ,	
Corporate	3,954,454,379	4,064,224,828	3.39%
Private	724,010,807	770,432,717	0.64%
Public	8,015,604,803	8,465,278,318	7.06%
Sovereign	822,396,365	877,412,999	0.73%
Other	20,501,291	20,467,865	0.02%
Private Mortgages:			
Commercial Whole Loans	1,489,785,909	1,595,294,244	1.33%
Commercial Mortgage Pools	88,579,181	96,981,035	0.08%
Single Family Participating Certificates	1,703,028	2,187,691	0.00%
Inflation Protected Securities Special Investments: Member Home Loan Programs:	541,303,045	536,767,000	0.45%
FNMA (Deliverables)	700,082,915	688,480,801	0.57%
FNMA (Nondeliverables)	774,125,531	776,749,606	0.65%
Jumbo	225,861,067	223,184,116	0.03%
Retirement Account Loans	30,702,635	30,702,635	0.13%
Retirement Account Loans Defaulted	367,456	367,456	0.00%

## SUMMARY OF SECURITIES OWNED (CONTINUED)

Сатедоту	Book Value	Market Value	% of Investment at Market Value
FIXED INCOME (CONTINUED)			
AFL-CIO HIT	77,065,158	77,322,012	0.06%
ULLICO	37,982,155	38,902,902	0.03%
Bridge Housing	6,412,362	6,412,362	0.00%
Equitable CCMF	19,270,654	19,694,870	0.02%
Total Internal Domestic Fixed-Income	\$27,059,908,785	\$28,053,224,262	23.38%
External Domestic Fixed-Income			
Mortgage-Backed Securities:			
FNMA	\$3,172,493	\$3,211,410	0.00%
U.S. Treasuries and Agencies	122,775,934	123,516,540	0.10
Other	4,145,077	4,019,920	0.00
Total External Domestic Fixed-Income	\$130,093,504	\$130,747,870	0.10%
TOTAL DOMESTIC FIXED-INCOME	\$27,190,002,289	\$28,183,972,132	23.48%
<b>External International Fixed-Income</b>	\$3,999,284,989	\$3,952,394,143	3.30
TOTAL FIXED-INCOME	\$31,189,287,278	\$32,136,366,275	26.78%
EQUITY			
DOMESTIC EQUITY:			
Internal Domestic Equity			
Corporate Stock:			
Index Fund	\$17,435,296,463	\$44,011,024,599	36.72%
Other Funds	35,676,067	11,333,138	0.01
International	15,855,717	42,253,034	0.04
Preferred Stock:		, ,	
Index Fund	3,999,885	4,184,611	0.00
Other Funds	106,136,964	128,006,251	0.11
Convertible Securities:			
Bonds	130,603,957	138,452,795	0.12
Preferred	1,320,769	1,393,750	0.00
<b>Total Internal Domestic Equity</b>	\$17,728,889,822	\$44,336,648,178	37.00%
External Domestic Equity:			
Corporate Stock	\$5,555,187,462	\$8,594,302,556	7.17%
Convertible Securities:			
Bonds	7,209,677	7,770,000	0.01
<b>Total External Domestic Equity</b>	\$5,562,397,139	\$8,602,072,556	7.18%
TOTAL DOMESTIC EQUITY	\$23,291,286,962	\$52,938,720,734	44.18%
EXTERNAL INTERNATIONAL EQUITY:			
Common Stock-Unhedged	\$7,702,895,064	\$9,622,282,029	8.03%
Common Stock-Hedged	10,596,277,406	13,245,586,826	11.05
Currency Options	15,822,119	11,596,854	0.01
TOTAL EXTERNAL INTERNATIONAL EQUITY	\$18,314,994,589	\$22,879,465,709	19.09%

### SUMMARY OF SECURITIES OWNED (CONTINUED)

Category	Book Value	Market Value	% of Investment at Market Value
EQUITY (CONTINUED)			
ALTERNATIVE INVESTMENT MANAGEMENT PROGRAM:			
Direct Component:			
Co-investments	\$129,461,613	\$132,850,476	0.11%
Direct Investments	499,999,955	499,999,955	0.42
Partnership Component:			
Domestic	1,884,818,878	2,010,211,786	1.68
Foreign	81,763,641	79,107,816	0.07
TOTAL ALTERNATIVE INVESTMENT MANAGEMENT PROGRAM	\$2,596,044,087	\$2,722,170,033	2.28%
TOTAL EQUITY	\$44,202,325,637	\$78,540,356,476	65.55%
REAL ESTATE PROGRAMS			
CORE REAL ESTATE INVESTMENTS:			
Real Estate Equities	\$2,981,378,059	\$2,404,759,463	2.01%
Real Estate Joint Ventures	1,720,761,679	1,399,128,772	1.17
Land	10,167,426	7,983,986	0.01
Commercial Mortgages	89,745,821	132,438,907	0.11
Sale/Leaseback	87,121,695	87,121,695	0.07
Other Mortgages/AFL-CIO Building	50,131,384	69,510,378	0.06
TOTAL CORE REAL ESTATE INVESTMENTS	\$4,939,306,064	\$4,100,943,201	3.43%
SPECIALIZED REAL ESTATE INVESTMENTS			
Single Family Land Acquisition & Development Prog	ram \$93,331,391	\$93,331,391	0.08%
Single Family Housing Program	210,221,906	210,221,906	0.17
Cadillac Fairview	234,603,165	8,521,702	0.01
Catellus Common Stock	580,653,246	686,709,984	0.57
Franchise Finance	172,910,484	185,268,236	0.15
Hotels	38,543,790	34,340,439	0.03
California Urban Investment Program	7,261,147	7,261,147	0.01
Timberland	522,396,151	1,035,140,887	0.86
TOTAL SPECIALIZED REAL ESTATE INVESTMENTS	\$1,859,921,280	\$2,260,795,692	1.88%
TOTAL REAL ESTATE PROGRAMS	\$6,799,227,344	\$6,361,738,893	5.31%
TOTAL INVESTMENT VALUE	\$85,022,935,895	\$119,869,980,240 1	100.00%

<sup>&</sup>lt;sup>1</sup> Differences between Total Investment Value in the Summary of Securities and Total Investments shown on page 10 are due to differences in reporting methods. In accordance with GASB Statement No. 28, the financial statements include Securities Lending Collateral as part of Total Investments, which is not included here. The Summary of Securities also includes Net Investment Receivables/Payables that are not reported on page 10 in Total Investments.

## PORTFOLIO OF CALIFORNIA INVESTMENTS AT MARKET VALUE

Category	CalPERS Total Portfolio (Dollars in Millions)	California Holdings (Dollars in Millions)	California Holdings % of Each Portfolio & Asset Class
REAL ESTATE			
Mortgages			
AFL-CIO Housing Investment Trust	\$77.3	\$3.1	4%
Bridge Housing Construction	6.4	6.4	100
Commercial (Whole Loans/MBS)	1,692.3	416.0	25
Equitable California Community Mortgage Fund	19.7	19.7	100
Member Home Loan Program	256.4	256.4	100
ULLICO	38.9	38.9	100
<b>Total Real Estate Mortgages</b>	\$2,091.0	\$740.5	35%
Equity			
Acquisition & Development Program	\$93.3	\$93.3	100%
AFL-CIO Building Investment Trust	69.5	13.2	19
Bay Area Real Estate (Catellus)	686.7	686.7	100
CNL Net Lease Program	185.3	33.4	18
CUIP	7.3	7.3	100
Equity	4,074.3	963.4	24
Housing Program	210.2	210.2	100
Timber	1,035.1	13.0	1
Total Real Estate Equity	\$6,361.7	\$2,020.5	32%
TOTAL REAL ESTATE MORTGAGES & EQUITY	\$8,452.7	\$2,761.0	33%
Equities			
Alternative Investments–Direct Component	\$632.9	\$0.0	0%
Alternative Investments–Partnership Component	2,089.3	377.5	18
Domestic Equity	52,938.7	6,882.0	13
International Equity	22,879.5	0.0	0
TOTAL EQUITIES	\$78,540.4	\$7,259.5	9%
FIXED-INCOME			
Domestic Fixed-Income			
Corporate Bonds	\$10,674.4	\$501.3	5%
Member Home Loan Program-FNMA	1,465.2	1,465.2	100
Mortgage Pass-Throughs/CMOs	9,765.6	2,832.0	29
Cash Equivalents	2,366.7	0.0	0
Treasury Bonds	4,187.7	0.0	0
Total Domestic Fixed-Income	\$28,459.6	\$4,798.5	17%
International Fixed-Income	3,952.4	0.0	0%
TOTAL FIXED-INCOME	\$32,412.0	\$4,798.5	15%
Receivables/Payables	\$464.8	\$0.0	0%
TOTAL INVESTMENTS	\$119,869.9	\$14,819.0 1	12%

<sup>&</sup>lt;sup>1</sup> Approximately \$15.4 billion has been committed for investment in California. The \$14.8 billion amount shown here represents investments to date.

### INVESTMENT OPERATIONS HIGHLIGHTS

CalPERS investment portfolio experienced tremendous growth during the 1996-97 fiscal year, earning more than \$19 billion. The Fund's total portfolio market value for the fiscal year ending June 30, 1997 was \$119.7 billion. The System returned 20.1 percent on its investments, well above last year's performance of 15.3 percent. This performance marked one of the largest annual gains by the System in recent years and illustrated the Fund's sustained strength and growth. Most of all, we exceeded our objective of high investment returns while carefully managing risk, a reminder to our one million members that their financial future is secure and growing steadily.



The markets confounded expectations during the 1996-97 fiscal year. We witnessed Wall Street's recording-breaking bull market send the Dow Jones Industrial Average on a nine-month surge. It marked the third year of 20 percent returns. The past 12 months will also go down as a stellar year for bonds, one marked by falling inflation, little change by the Federal Reserve and rising prices on almost all types of bonds.

The CalPERS Board of Administration's asset allocation decision to increase the Fund's exposure to the U.S. equity market once again served as the foundation of the Fund's success. We witnessed our U.S. equity investments earn an astounding 30.6 percent return. Furthermore, the resurgence of the Japanese stock market combined with the sharp appreciation of the yen provided a wealth of gains for

CalPERS as our international equity portfolio provided a solid return of 18 percent.

Overall, the stock market's strength sustained several trends throughout the year. Corporate restructuring boomed, privatization brought foreign companies to the U.S. market, institutional investors steadily increased their foreign share ownership, and there was virtually a rush into the world's emerging markets. As a result, the markets provided some very attractive opportunities, and CalPERS took advantage of them.

In December 1996, CalPERS formed an historic partnership with the prestigious Asian Development Bank (ADB), committing \$225 million to make long-term, direct private equity investments in the emerging markets of the Asian-Pacific region. The strategic alliance was an international first, both for CalPERS and the international multi-lateral bank. The investments were targeted to finance a variety of ventures, including industry and financial services in the region. It was a pioneering effort for the Fund and allowed CalPERS access to the excellent opportunities that are unparalleled in the region. Moreover, the partnership spanned a bridge for cross-capital flows between Asian Pacific investors and California companies.

The ADB agreement helped us boost returns in our private equity asset class with the greatest of risk protection. The Fund's alternative and private equity investments earned 14.4 percent for the year.

The fiscal year marked a focused effort on individual corporate board performance and accountability in the System's domestic and international corporate governance programs. In a major expansion, we embarked on the next evolutionary step of our shareholder activism. We began the development of a set of U.S. "Corporate Governance Principles and Guidelines" to serve as one institutional investor's perspective on issues of board independence and leadership, board processes and evaluation, and individual board member characteristics. The principles will be designed to foster debate in the corporate governance arena and—as a whole—will be

### INVESTMENT OPERATIONS HIGHLIGHTS (CONTINUED)

important considerations for all companies within the U.S. market that seek to survive in today's increasingly competitive environment.

Additionally, CalPERS was vigilant in the first year of the System's International Corporate Governance Program. The Board formally adopted a set of global corporate governance principles and best practices that focused on six basic concepts that are fundamental to free and fair markets throughout the world, without impinging upon the legal, economic and cultural traditions of each country. Moreover, the principles reflect the core of the corporate/shareholder relationship addressing accountability, transparency, equal treatment for all shareholders, voting methods, and long-term corporate vision. Using these as a core foundation for our international corporate governance efforts, we further developed corporate governance principles for our investments in the United Kingdom and France.

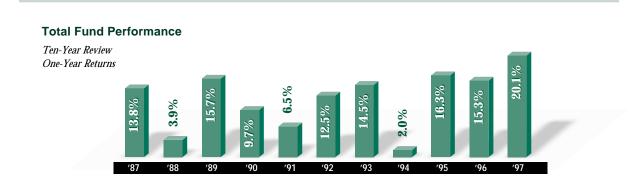
The effort was timely. Global competition drove the reassessment and restructuring of corporate governance systems in several foreign countries. The principles served as a road map to help guide us to influence the emergence of shareholder-oriented corporate governance programs abroad and in turn helped produce significant returns for the Fund.

And once again, the CalPERS Board adopted a twotier approach to our corporate governance program, targeting 10 "focus" companies and increased monitoring of 20 other poorly performing companies. CalPERS exercised its stature as a leader and activist in the private equity market as well. Working with eight of the nation's top public pension funds, we campaigned for better terms and conditions as a limited partner investor in the private equity market. We challenged general partners to adhere to some model best practices that would ensure fair general partner compensation, greater alignment of interests and increased accountability. The recommendations were outlined in a private equity partnership study conducted by William M. Mercer, Inc. and represented the first time public pension funds collaborated on a such an industry report.

The 76-page report "Key Terms and Conditions for Private Equity Investing" documents widespread concern about the way in which equitable terms and conditions have evolved with private equity partners. The study addressed two fundamental questions:

- Are financial interests aligned between general partners and limited partners?; and
- Do the ongoing management practices of partnerships represent a continual alignment between general partners and limited partners?

The study identified over 30 terms and conditions in private equity contracts which could be improved or added in the limited partner/general partner relationship. By creating best practices in compensation structure, information disclosure, and accountability, CalPERS laid the foundation for increased cost savings and long-term quality of limited partnership investments.



### INVESTMENT OPERATIONS HIGHLIGHTS (CONTINUED)

Of equal importance, CalPERS excellent investment performance came at a low cost to the System. According to a study issued by Cost Effectiveness Measures, Inc. (CEM) in November 1996, the Fund's investment related expenses were extremely cost effective without sacrificing the quality of the investment program. The study concluded that CalPERS spent one tenth of one percent of the Fund's value, \$96.8 billion at the time of the study. We achieved value-added investment results equal to or in excess of other large multi-million dollar corporate and public pension funds.

In an effort to narrow our costs further, CalPERS Board voted to support the Common Cents Stock Pricing Act of 1997 that implemented decimal pricing of equity securities. The change makes it simpler for investors to know the price of equities and could potentially offer savings for investors by a reduction in the spread—the difference between the price paid by the trader to buy the equity and the price charged by the trader to sell the stock. By the fiscal year-end, we witnessed U.S. stock exchanges transition in the new pricing system. It is estimated that when complete, CalPERS could save more than \$1 million annually on reduced trading spreads in equity transactions.

### INVESTMENT POLICY & STRATEGY

The CalPERS Board has investment authority and sole responsibility for the management of assets. A complete set of regulations serves as a guide for the Board's Investment Committee, CalPERS management, and staff for carrying out the daily activities of the investment program. Investment policies are formally reviewed through the System's Investment Policy Subcommittee and receive final approval by the Investment Committee.

#### Asset Allocation

One of the most important policies and investment strategies set by the Board is its asset allocation decision. It is essentially the starting point and most important component for CalPERS to achieve successful returns on its investments. In the long run, it is the way the Fund diversifies stocks, bonds, cash and other investments that is largely responsible for the System's returns. The asset allocation decision is not an asset-only or liability-only decision. All factors, including liabilities and contributions, are taken into

account in determining the appropriate asset allocation mix. The Board approves a target allocation with investment range guidelines for each asset class.

There are two types of asset allocations: strategic and tactical. Strategic asset allocation is the basis for long-term asset allocation targets for each asset class. Within each asset class, ranges are included in the policy to provide the flexibility to take advantage of market opportunities. Information is received from staff, research services, and money managers. This forms the tactical asset allocation which allows shifts between classes to take advantage of emerging or rapid market opportunities.

In addition to CalPERS asset allocation policy, the following investment objectives have been established for the portfolio.

#### Inflation

Achieve a total portfolio return of 4 percent in excess of the U.S. Consumer Price Index.

### INVESTMENT POLICY & STRATEGY (CONTINUED)

#### **Actuarial**

Achieve a total portfolio return above the assumed actuarial interest rate, currently 8.5 percent for the period July 1, 1996 through June 30, 1997.

#### **Performance**

- 1. For the internal equity index portfolio, achieve a return equal to the Wilshire 2500 Index, plus or minus 50 basis points.
- 2. For externally managed assets, meet specific performance objectives related manager investment style, outlined in manager contracts.

- 3. For internal domestic fixed-income instruments, achieve a return in excess of the Salomon Brothers Large Pension Fund Index.
- 4. For equity real estate, achieve a least a 5 percent real rate of return.
- 5. For alternative and private equity investments, achieve an annual hurdle rate of 15 percent.

### **CalPERS Asset Allocation**

(June 30, 1997)

Asset Class	Market Value (\$ Billion)	Current Allocation	Target	Asset Return
Cash Equivalents	\$1.8	1.5%	2.0%	5.7%
FIXED-INCOME				
Domestic	28.0	23.3	24.0	9.9
International	4.4	3.7	4.0	5.5
TOTAL FIXED-INCOME	\$34.2	28.5%	30.0%	9.3%
Equities				
Domestic	\$52.7	44.0%	38.0%	30.6%
International	23.8	19.9	20.0	18.0
Alt. Inv./Private Eq.	2.7	2.3	5.0	4.4
TOTAL EQUITIES	\$79.2	66.2%	63.0%	26.2%
REAL ESTATE	\$6.3	5.3%	7.0%	13.5%
TOTAL FUND	\$119.7	100.0%	100.0%	20.1%

#### REDEFINING OUR APPROACH

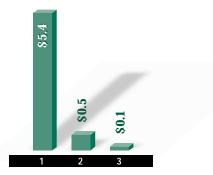
To ensure continued strong earnings and prudent management of risks well into the next century, CalPERS developed and began implementing comprehensive investment strategies in our alternative investment and private equity, real estate, and public markets portfolios. With these strategies in place we began a process of specialized oversight and management of these programs.

#### Alternative Investments & Private Equity

CalPERS began a proactive approach to the private equity market in the 1996-97 fiscal year. The effort stemmed from a report conducted early in the year that found the System's alternative investment and private equity portfolios well-positioned for growth, but could benefit from greater flexibility and responsiveness in an often fast-paced market.

## Alternative Investment Management Portfolio Summary

(Committed \$ in billions)



- 1. PARTNERSHIP COMPONENT DIRECT COMPONENT
  - 2. Direct investments
  - 3. Co-investments

The Board re-organized the way it invests in the private equity market. We consolidated the Fund's three existing programs, including our Alternative Investment, Alternative Emerging Investment Opportunity, and Private Equity programs into one program—the Alternative Investment Management (AIM) Program. We began proactively seeking investment opportunities

that offered the best value on a risk-adjusted basis. We streamlined our internal approval process to allow the Fund to react quickly to market opportunities. We sought to continue profitable general partnerships and expand our direct investment efforts.

AIM provided CalPERS more direct control over the types of investments in the program, and sent a clear message to the investment community about the type and structure of deals worthy of consideration.

CalPERS Board has allocated 3 percent of the total Fund for investment in alternative investments and 2 percent to private equity investments that include co-investments as part of the AIM program. AIM has approximately \$5.4 billion in commitments to 84 limited partnerships investments, of which over \$2.1 billion has been invested. Approximately \$666 million has been committed to eight direct investments and co-investments.

#### Real Estate

CalPERS continued to evaluate and analyze its real estate portfolio during the year in an effort to maximize returns to the System. Our Real Estate Subcommittee and investment staff worked diligently to develop and begin implementing a comprehensive strategy for the System's \$4.2 billion core real estate portfolio of apartment, office, industrial and retail properties. The Real Estate Subcommittee delegated the authority to implement the strategic plan to the System's senior investment officer for real estate. The delegation granted staff authority over asset transfers, tactical asset allocation, acquisitions and dispositions, retention and termination of the System's real estate advisors, and implementation of approved plans.

The strategy fostered a new approach toward the management structure an policies of CalPERS real estate portfolio. It calls for maximized focus and dedication by requiring that a team of professionals work exclusively on CalPERS portfolio; it allocates CalPERS existing real estate assets into subportfolios based on property type and region; it maximizes alignment of interests through co-investment and fee

### REDEFINING OUR APPROACH (CONTINUED)



structures based on cost to effectively implement the strategy with the majority of profit paid only when CalPERS realizes profits; and it provides CalPERS the opportunity to consider strategic alliances with management teams including investment advisors, and public and private operating companies.

The strategy has several advantages. A dedicated team ensures clear lines of responsibility and accountability with an understanding of CalPERS approach and objective. The strategy also provides a focus by property type and region that helped facilitate selection of management teams on expertise in specific metropolitan areas. Furthermore, the strategy's fee and co-investment structure provides an incentive for superior performance and aligned interests with CalPERS. The System's real estate portfolio earned a 13.5 percent, well above the NCREIF Property Index return of 10.2 percent for the year.

By the fiscal year-end, we had begun implementing the strategy that included a nationwide search for management teams to manage the System's apartment, office, industrial and retail portfolios. In addition, we began program reviews of our remaining \$2.1 billion in the portfolios devoted to specialized real estate assets, such as timber, housing, land and other specialized programs.

#### Global Public Markets

Public market investments represent the largest portion of CalPERS investment portfolio. More than \$76 billion was invested in the U.S. and internal equity markets and roughly \$32.4 billion invested in domestic and international fixed income at the end of the fiscal year.

Approximately 84 percent—or \$44.3 billion—of the Fund's domestic equity assets are passively managed internally and \$1.3 billion managed by one external small capitalization passive manager, while the remaining 13 percent are managed actively by external fund managers. The System's \$28 billion domestic fixed-income portfolio is managed internally, while CalPERS total international equity and fixed-income portfolios valued at \$28.2 billion is managed externally, using 14 investment managers. Eight of the managers are equity

## CalPERS International Investments

UP TO \$25 MILLION	\$100 - \$300 million
CHANNEL ISLANDS	Brazil
CHINA	Belgium
Cayman Islands	Denmark
BERMUDA	Finland
LUXEMBOURG	Indonesia
LOXEMBOOKG	Mexico
\$25 - \$50 million	New Zealand
Austria	PHILIPPINES
Norway	SINGAPORE
Taiwan	\$300 - \$500 million
Thailand	Malaysia
\$50 - \$100 million	SOUTH AFRICA
QUO QUO MILLION	
ARCENTINA	\$500 MILLION - \$1 BILLION
ARGENTINA Chile	\$500 MILLION - \$1 BILLION
CHILE	Australia
	Australia Canada
CHILE GREECE	Australia Canada Hong Kong
CHILE GREECE IRELAND	Australia Canada Hong Kong Italy
CHILE GREECE IRELAND KOREA	Australia Canada Hong Kong
CHILE GREECE IRELAND KOREA PORTUGAL	Australia Canada Hong Kong Italy Sweden Spain
CHILE GREECE IRELAND KOREA PORTUGAL SUPRANATIONAL	Australia Canada Hong Kong Italy Sweden
CHILE GREECE IRELAND KOREA PORTUGAL SUPRANATIONAL	AUSTRALIA CANADA HONG KONG ITALY SWEDEN SPAIN OVER \$1 BILLION FRANCE
CHILE GREECE IRELAND KOREA PORTUGAL SUPRANATIONAL	AUSTRALIA CANADA HONG KONG ITALY SWEDEN SPAIN OVER \$1 BILLION
CHILE GREECE IRELAND KOREA PORTUGAL SUPRANATIONAL	AUSTRALIA CANADA HONG KONG ITALY SWEDEN SPAIN OVER \$1 BILLION FRANCE
CHILE GREECE IRELAND KOREA PORTUGAL SUPRANATIONAL	AUSTRALIA CANADA HONG KONG ITALY SWEDEN SPAIN OVER \$1 BILLION FRANCE GERMANY

UNITED KINGDOM

### REDEFINING OUR APPROACH (CONTINUED)

Domestic Equity Investments (\$\mathcal{S}\$ in Billions)		
	Market Value	% of Portfolio
Internal Portfolios	\$44.3	37.0%
EXTERNAL PORTFOLIOS	8.6	7.2
Total	\$52.9	44.2%

managers, including seven active international equity managers and one passive international equity index fund manager. Four of the managers are international fixed-income managers, while the remaining two are global asset allocators. The Board also contracts with three currency overlay managers to manage a portion of the currency exposure of CalPERS passive international equity investments.

During the year, CalPERS began the first phase of a new public market strategy. The Board voted to reorganize management of its domestic equity portfolio. The plan authorized the development of an internal active management capability to manage a portion of the Fund's domestic equity in-house; it revamped the pay-for-performance fee schedule to better align interests of CalPERS and its managers; it created specialized benchmarks for each manager for evaluation and monitoring purposes; it called for a

Fixed-Income Investments		
(S in Billions)		
	Market Value	% of Portfolio
Domestic	\$28.2	23.5%
International	3.9	3.3
Total	\$32.1	26.7%

specialized passive management fund to complement active management performance; and it streamlined the external manager contracts solicitation process to attract more applicants capable of adding value to the Fund.

The strategy also marked a first for the System. CalPERS launched an interactive nationwide search for active domestic equity managers and a passive small capitalization manager on the World Wide Web. It was a tall order for a public agency that historically solicited bids through voluminous paper invitations under stringent bureaucratic rules. The request for proposals(RFP) were designed to attract a broad universe of potential firms that were capable of adding value to the Fund. With the RFP, CalPERS tapped into available technology to provide interested bidders with a simple, accessible, easy to use process. Traditional searches brought the System about 80 proposals. Our Internet RFP netted 270 proposals—a 300 percent increase.

Company	Shares	Market Value
GENERAL ELECTRIC CO.	16,786,800	\$1,097,437,050.00
COCA-COLA CO.	12,691,700	856,689,750.00
EXXON CORPORATION	12,460,400	766,314,600.00
Microsoft Corporation	6,019,400	760,701,675.00
Merck & Co. Inc.	6,498,000	672,543,000.00
INTEL CORPORATION	8,432,400	597,909,862.50
PHILIP MORRIS CO.	11,910,900	528,546,187.50
International Business Machines	5,396,000	486,651,750.00
PROCTER & GAMBLE CO.	3,396,952	479,819,470.00
Johnson & Johnson	6,707,010	431,763,768.75

#### CORPORATE GOVERNANCE

After more than a decade as a leader and shareowner activist in both the U.S. and international markets, it is clear how vital a role directors and boards play among the world's companies and markets. CalPERS has learned over the years that directors and boards end up on the right side of almost any issue when they make the interests of shareowners their touchstone.

This formula has become increasingly more important as the corporate governance movement continues to drive change in our capital markets.

Today's corporate governance landscape is truly dynamic. Representative of this fact have been a few major themes that emerged during the fiscal year.

First, we witnessed the ranks of shareowner activists grow with the addition of several new players. While traditional institutional investors continue to dominate and step up their governance efforts, an increasing number of unions and mutual funds pushed for increased shareowner value and exercised their voice in a number of proxy contests.

Second, we witnessed the birth of corporate governance guidelines and principles, including CalPERS initial development of its own corporate governance principles.

#### 1997 Corporate Governance "Focus Companies"

APPLE COMPUTERS ROLLINS ENVIORNMENTAL

BASSETT FURNITURE SERVICES

INDUSTRIES SENSORMATIC ELECTRONIC

FLEMING COMPANIES, INC. STRIDE RITE CORPORATION

NOVELL, INC. SUMMIT TECHNOLOGY, INC.

REEBOK INTERNATIONAL,

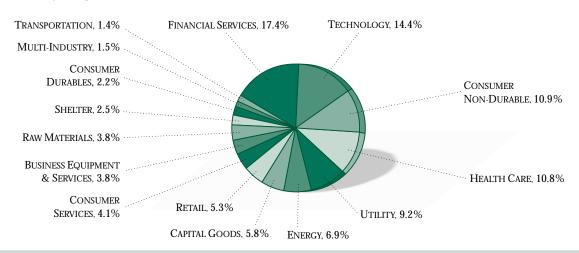
LTD. Sybase, Inc.

CalPERS was vigilant in its proxy voting during the year. We voted on proxies for over 1,800 domestic companies whose market value totaled \$52 billion and approximately 780 international companies with a total market value of \$23.7 billion

Several prominent issues emerged on the domestic and international proxy scene. Election of directors, stock option plans, bonus plans, director compensation, capital increase authorizations, mergers and shareowner proposals

## Domestic Equity Sector Distribution of Common Stock

(Internally Managed Portfolios)



### CORPORATE GOVERNANCE (CONTINUED)

were among those issues that faced investors and America's corporations.

On the international front, the election of directors, acceptance of financial statements (including dividends), and appointment of auditors were issues that struck the interest and activism of institutional investors.

CalPERS remained active during the year continuing its two-tier approach to our corporate governance program, focusing its activism on 10 underperforming companies while closely watching an additional 20 poor performers. We also voiced our opinions through our proxy votes at a number of companies with poor corporate governance practices during the year.

Additionally, we remained steadfast in our efforts to share our experiences and influence the practices of good corporate governance in the international markets. The effort was realized through our Board's adoption of a set of global corporate governance principles and best practices and market specific principles for the United Kingdom and France.

Clearly, the practice of corporate governance has become a dominant and focused theme in the U.S., and increasingly abroad. We will continue the crusade for a more robust corporate governance framework that instills improved corporate performance, long-term vision, and shareowner value. In both the domestic and international marketplace, we will seek a greater focus on quality directors who are independent of management and have the skills vital to long-term success of corporations.

We hope that our program will stimulate further debate and discussion about appropriate corporate governance practices. By working with investors in the U.S. and abroad, CalPERS hopes that its voice, experience, and support can help corporate governance systems grow in a way that focuses on shareowner value in changing global markets.

### A California Focus

Fulfilling our commitment to seek investments that strengthen California's economy, we continued a proactive approach in making prudent investments in the State. Through a number of programs including private equity investments, limited partnerships, single family housing, acquisition and development, and home loans, CalPERS diversified its portfolio while providing a powerful economic stimulus to California's growth. Approximately \$15.4 billion has been committed by the System for investment in California, of which \$14.8 billion is invested.

CalPERS Single Family Housing Program continued to generate new home construction in California. With a \$525 million allocation, the program pulled in returns in excess of 20 percent for the Fund. We continued to diversify and manage our portfolio while providing thousands of jobs and services. In addition, the System has committed \$455 million in its Acquisition & Development Program, residential land development program exclusive to California. Of CalPERS total real estate investments, approximately \$3.7 million were committed for investment in our state.

The Fund's successful Member Home Loan Program, which provides up to 100 percent financing on home mortgages, continued to help CalPERS members realize the American dream of home ownership. The System has funded more than 45,000 home loans worth more than \$5.5 billion since inception of the

### A CALIFORNIA FOCUS (CONTINUED)

program in 1981. To ensure growth of the program, we began providing members information about the benefits to purchase or refinance a home through the Internet. CalPERS Web Site provides members with

California Committed Investments	
(\$ in Billions)	
Equities	\$7.0
REAL ESTATE	3.7
FIXED-INCOME	4.7
Total	\$15.4

the opportunity to access an approved CalPERS lender in order to get prequalified, provides interest rates on a daily basis, and allows members to e-mail with questions on the program.

Finally, we sought to provide valuable venture capital for the state's innovative high technology and biotech industries through limited partnerships in the System's AIM Program. Approximately \$555 million has been committed for investment in eight limited partnerships that take advantage of a number of factors conducive to targeted investment activity within the state, including the unique size characteristics of California's economy and the states large number of business entities and development cycles.

### SECURITY ANALYSIS & RESEARCH

The Securities Analysis and Research Unit provides inhouse research, analysis, and recommendations in the areas of fixed-income, equity, private equity, real estate, and corporate governance to assist in making investment decisions. Ongoing monitoring of fixed-income securities and real estate transactions includes annual industry reviews. Staff review all existing fixed-income holdings and provide an industry overview.

The research unit also provides the initial screening, analysis, and recommendation regarding the selection of underperforming companies for the CalPERS corporate governance activities and provides analysis on selected target companies. Other duties include review of corporate actions, including mergers, acquisitions, and tender offers, as well as review of private equity transactions.



# ANNUAL INVESTMENT REPORT CD-ROM LOADING INSTRUCTIONS

#### Windows 3.1

Using the RUN option of the Program Manager File Menu, browse and select "Setup31.exe" from the CalPERS CD-ROM.

#### Windows 95

Using the RUN option of the Start Menu, browse and select "Setup95.exe" from the CalPERS CD-ROM.

#### Macintosh

The CalPERS CD-ROM will automatically display on the Desktop when loaded. Double-click on the icon labeled "Install."

#### MINIMUM SYSTEM REQUIREMENTS:

*Windows:* 486 with 66MHZ CPU (Pentium Recommended); Windows 3.1 or Windows 95; 16MB RAM; 640x480 display, 256 colors; Double speed CD-ROM drive; Sound Blaster Sound Card *Macintosh:* 68040 (Power PC Recommended); System 7.1 or higher; 16MB RAM; 640x480 display, 256 colors; Double speed CD-ROM drive

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